HELP ?

Developing GCC stock markets: The private-sector role

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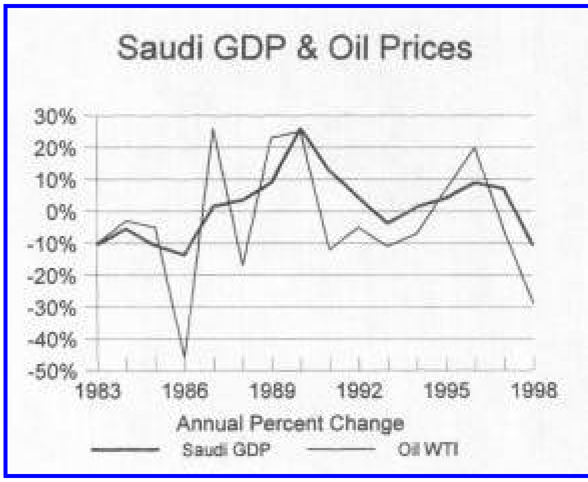
Abstract:
It is time for attention to be given to strengthening the capital markets of the Gulf Cooperation Council (GCC). These markets will act as a cushion for volatile oil prices by pumping private wealth into the local financial system, thus minimizing the power of swings in oil prices that determine government revenues.

Full Text:

Driving a car on a highway for a 1,000-mile trip doesn't really require much expertise (assuming you keep your eyes open and read the road signs), but reaching your final destination in the center of a big city takes more advanced skills. This is roughly analogous to the journey to economic development by the states of the Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates). For the past half century, government revenues from oil sales have been the major engine of economic development. As a result, the basic infrastructure was built from scratch. "Precision" economic planning was not required. Hence overdevelopment and lack of synergy is evident. For example, each of the six GCC members has its own airline even though GCC capitals are only an hour or two apart.

Like other globally traded commodities (gold, copper, etc.) whose values can fluctuate a great deal (see table 1), oil prices have a high volatility, making the economic planning of an oildependent country a difficult task. Since 1983, in 10 out of 16 years oil prices (WTI yearly average) increased or decreased by more than 10 percent. It is difficult enough in a well-diversified developed country to increase real GDP by 1 to 3 percent annually. To be able to plan economic growth for countries where 50 percent or more of their GDP depends on a single volatile commodity is a formidable challenge.

With the basic infrastructure completed, GCC economies have reached a point where there is a serious need for economic fine-tuning in order to minimize the impact of volatile oil price volatility and its damaging after-shocks. Oil is becoming more of a risk than an asset. The financial markets, with the full and active participation of the cash-rich local private sector, offer an essential tool for diversifying GCC economies out of oil-dependency and the associated government spending.



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Saudi GDP & Oil Prices

Table 1: West Texas Intermediate And Saudi Nominal GDP

Year	WTI Yearly Average		Saudi Nominal GDP	
	USD/Barrel	Change	SAR Billion	Change
1983	30.4	-10%	372.0	-18.4%
1984	29.4	-3%	351.4	-5.5%
1985	28.0	-5%	313.9	-10.7%
1986	15.2	-46%	271.1	-13.6%
1987	19.2	26%	275.5	1.6%
1988	16.0	-17%	285.1	3.5%
1989	19.6	23%	310.8	9.0%
1990	24.5	25%	392.0	26.1%
1991	21.6	-12%	443.0	12.8%
1992	20.6	-5%	461.4	4.4%
1993	18.4	-11%	443.8	-3.8%
1994	17.2	-7%	450.0	1.4%
1995	18.4	7%	469.1	4.2%
1996	22.0	20%	511.0	9.0%
1997	20.6	-6%	547.0	7.0%
1998	14.6	-29%	487.9	-10.7%

Source: SAMA, IIF & [illegible]

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Table 1: West Texas Intermediate And Saudi Nominal GDP

It must be mentioned that various market estimates indicate that GCC citizens own some $500 billion in liquid financial assets (cash, stocks, mutual funds, etc.) held outside the GCC financial systems. It is possible to attract back a sizable portion of these assets if investors can be convinced of the merits, and thus the private wealth will act as a safety "airbag" to cushion the impact of an oil-price crash.

A major pillar of a free-market economy, the stock market can be thought of as a place (the stock exchange) in which suppliers of money (investors) offer their capital to buy financial assets (company shares) from suppliers (companies) through mediators (investment banks or brokers), where the capital raised will be utilized in starting new companies. This is the primary stock market. Investors also have the objective of selling their shares in the future, in addition to collecting their annual cash dividends, for a profit in the secondary market. The cycle goes on, maximizing the productivity of money as the participants profit and their economies develop. Although real life does not precisely fit this ideal model, it comes close to it.

A LOOK AT GCC STOCK MARKETS

With the exception of the very lively Kuwait Stock Exchange, most of the GCC exchanges are still in their infancy. The UAE is expected to have a formal exchange in early 1999 (currently, the UAE stock market is a $27 billion unregulated business), while Saudi Arabia has no official exchange. The Saudi Arabia Monetary Agency (SAMA), the de-facto central bank, sponsors a sophisticated computer-based stocktrading system, the Electronic Securities Information System (ESIS). Qatar has recently established DSM (Doha Securities Market), while the Bahrain and Oman exchanges have been in operation for a few years. These exchanges are either government-run or semigovernment-run. For the security exchanges to flourish and be able to attract local "immigrant" money, the private sector should be given a bigger role in running them. This is a very delicate issue, since most governments are rightfully worried about uneducated small investors falling victim to pushy brokers and bad stocks. To their credit, no GCClisted company has gone bankrupt. Nevertheless, it should be mentioned that a few GCC-listed companies have witnessed a price collapse either because of incompetent management or unfavorable business positioning. It is not possible for any regulator to completely prevent such failures.

Table 2: Saudi Stock Market Characteristics

Category	Saudi Arabia	Emerging Markets (IFCG, Average of 33 Countries)
Market Capitalization	USD 45 Billion, Rank 13th	USD 53 Billion
Annual Market Turnover	USD 14 Billion, Rank 15th	USD 60 Billion
Turnover/Capitalization	32%, Rank 28th	112%
Number of Listed Companies	74 Companies, Rank 30th	518 Companies
Average Company Size	USD 608 Million, Rank 3rd	USD 103 Million

As of 17-Oct-98 Source: IFA & IFC

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Table 2: Saudi Stock Market Characteristics

Protecting small investors is no easy task, but creating laws to enforce high standards of disclosure and transparency (as is the case of other stock markets) will minimize this risk. While fraud can never be eliminated, it can be prosecuted harshly to protect innocent investors. Having a watchdog body like the American SEC is a plus for any financial system.

CASE STUDY: THE SAUDI STOCK MARKET

Let us look in more detail at the Saudi stock market, the largest not only in the Gulf but in the Arab world. Table 2 represents a quantitative comparison of the Saudi stock market with those of other emerging markets (represented by the International Finance Corporation Global (IFCG) Universe).

Market Size: The Saudi stock market ranks thirteenth of the 33 markets composing the IFCG universe. The sheer size of the Saudi market forces global fund managers investing in emerging markets to keep a close watch on it. The high ranking of the Saudi market should be looked upon within the context of the past year's crash of emerging global markets. The Saudi market achieved its high ranking because other markets have lost considerable value (for example, in 1998, Russia was down by 80 percent while Turkey and Venezuela lost 50 percent). It should be noted that the size of a stock market is highly dependent on the introduction of new listings (Initial Public Offerings, or IPOs). For the past five years new listings contributed a meager 2 percent of the current size of the Saudi market. The market needs a continuous flow of new companies for it to be able to grow.

Market Turnover: The annual turnover (value of stocks traded per year) is about $14 billion, 77 percent less than for other comparable emerging markets. The Saudi market is considered shallow when compared to its peer group. This becomes clearer when we look at the turnover as a percentage of size, 32 percent compared to 112 percent for other emerging markets. This weakness also characterizes other GCC stock markets. There are two reasons behind this low trading volume: (1) the governments still hold a large chunk of listed firms that they rarely trade, and (2) strategic shareholders (either major local families or foreign jointventure banks - the Saudi American Bank (SAMBA) is 30-percent-owned by Citibank; and the Saudi Arabian British Bank (SABB) is 40-percent-owned by the HSBC group (Hong Kong Shanghai Banking Corp.)) hold another large chunk. This makes shares available for trading very limited, causing investors to shy away from these companies. One way to fix the problem is for local governments tc gradually liquidate their holdings.

Number of Listed Shares: 74 different companies are traded on the Saudi stock market, compared to an average of 350 companies in other emerging markets. The reason for this small number of companies is the stringent listing requirements imposed by the Ministry of Commerce (MOC), which has encouraged the listing of large well-established companies. It also should be mentioned that the top ten of these companies represent 60-70 percent of the overall market (measured by any indicator: size, turnover or profit). A careful look at the corporate structure of the Saudi economy reveals that there is a large number of family-owned businesses that have not listed their stocks. Encouraging and helping these companies to go public will not only increase the size of the market but will also ensure their longevity when they run on the basis of merit rather than family relationship.

Market Regulations: Since SAMA and MOC have the responsibility of overseeing the stock market, they are at times in an unenviable position. For example, when a company does not publish its financial statements on time (as required by law), it is incumbent on one of these governmental bodies to force compliance by censuring or de-listing the shares from trading. Riyad Bank has consistently refused, for reasons yet to be made public, to publish many of its quarterly statements for the past few years. IF SAMA or MOC censures Riyad Bank publicly (which most independent stock exchanges would not hesitate to do), then local depositors might misunderstand the issues at stake. This could result in the unwarranted catastrophe of a run on the bank.

Private-Sector Role: GCC regulators should give the private sector a leading role in running the exchanges and should encourage small- and medium-size startups to be listed because in many cases local entrepreneurs can help develop diversified sectors more efficiently than behemoths. Private entities are better off running their own affairs when their livelihood depends on it. Let us keep in mind Microsoft and Bill Gates in his garage startup and what he was able to achieve in two decades.

THE EFFECT OF GLOBALIZATION

The global turmoil in emerging markets that started in July 1997 has created controversy about what can be considered safe assumptions. Let us shed some light on issues that are relevant to GCC financial markets.

Foreign Capital: Over-borrowing by the private or public sector in the international capital markets can cause dire consequences when the "herd" run-out effect begins. Looking at the effect of foreign pullout from Southeast Asian capital markets, we cannot but wonder if, all things considered, the presence of this capital was a net plus or minus. The GCC still has abundant cash and is still a capital-exporting entity, but the real need for foreign capital is very limited. It should nevertheless be encouraged. Direct foreign investment in the form of joint ventures coupled with transfer of technical know-how should be always welcomed. In addition, foreign long-term institutional funds (e.g. pension funds) must be welcomed, while at the same time strong defensive lines should be built to keep any short-term speculators safely at bay. Chile requires a minimum investment period of one year, for example.

WTO: With the GCC having stated its desire to join the WTO, local financial markets must open up to foreign financial institutions sooner or later. There is a grace period before this happens, and this should be the "last call" to strengthen local financial institutions, particularly in the non-existent investment-banking and financial-services areas.

Financial Services: Commercial banks play the major role in all aspects of the GCC financial system. Saudi Arabia doesn't have laws to permit anything but commercial banking. Investment banks, brokerage houses and even insurance firms are not licensed to operate. Besides the obvious weakness of not having these firms, a question mark hangs over commercial-banking activities and the potential conflicts of interest arising for such a system. For example, Saudi commercial banks act as lenders to corporations (thus having access to privileged financial and business information) while at the same their assetmanagement divisions invest the bank's own capital as well as other clients' money in the shares of these corporations. Separating these activities by permitting the establishment of investment firms would remedy the problem. The introduction of compulsory pension funds for all employees (citizens or guest workers) would not only benefit the pensioners but would act as the backbone for the development of a local investmentmanagement industry.

Bank Mergers: There are quite a few under-capitalized banks in the GCC financial arena that have little chance of surviving competition with the big supermarket banks. Non-niche small banks should be encouraged to merge to strengthen the overall system. Otherwise the fall of one tiny bank might affect the consumer's psychological confidence in the whole system, even though little if any money might be lost.

CONCLUSION

It is time for attention to be given to strengthening the capital markets of the GCC. These markets will act as a cushion for volatile oil prices by pumping private wealth that was accumulated during the oil boom into the local financial system, thus minimizing the power of swings in oil prices that determine government revenues. Many useful lessons applicable to GCC financial systems can be learned for free from the recent turmoil in other emerging markets. The age of globalization is coming, and he who does not have his house in proper order shall hurt his whole family. The private sector is more than eager to play a leading role in developing the local financial system, if it were given a chance.

[Author note]

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